GLOBALISATION

Globalisation refers to the growing integration and interdependence of the world's economies.

Characteristics of Globalisation :

1) An increase on trade as a proportion of world GDP
2) An increase in migration between countries
3) The growing importance of TNCs and FDI through the development of global brands

Factors contributing to globalisation :

1) Reduced cost of transportation :
   Average transport costs have fallen significantly over the last 50 years. The use of larger planes and ships has allowed firms to gain from economies of scale. Technical efficiencies have also been gained through 'containerisation', which made it cheaper to transport goods in freight ships and lorries. Increase in fuel efficiency and better transport infrastructure across the world such as seaports, airports, rail networks has enabled goods to be distributed more easily and cheaply.

   Evaluation :
   Landlocked countries are not going to benefit as much from containerisation as compared to those countries with access to seaports. Smaller countries do not have seaports for larger ships and have to resort to air cargo. A fall in transport cost per unit is not as significant for these countries.

2) Reduced cost of communication :
   The increased availability of internet, mobile technology and other technological advances have made it easy to communicate and share information worldwide in real time and at affordable prices. Additionally the introduction of online stores like Amazon and Alibaba along with electronic payment systems has simplified the trading process.

   Evaluation :
   Many people in developing countries are excluded from the benefits of internet or mobile technology due to being poor, being illiterate or having no access to computer systems.

3) Trade liberalisation :
   The WTO has been responsible for negotiating reductions in tariffs and non-tariff barriers in rounds of talks, the most recent of which is the Doha Round held in 2001. This has led to countries specialising as per their comparative advantage and engaging in more international trade.

   Evaluation :
   However, trade talks of Doha round which started in 2001, have been unsuccessful in reducing trade barriers because USA and EU are not willing to give up their agricultural subsidies. WTO has also been less successful in reducing non-tariff barriers.

4) Political Change :
   The breakdown of the Soviet Union and transformation of China towards a more market-based economy meant that these economies opened up to foreign trade and investment. In 2001, China joined the WTO and this had a big impact on globalisation due to the size of its economy and population. Manufacturing jobs shifted to China and it is now the largest exporter in the world.

   Evaluation :
   The US-China trade war and Russia-Ukraine conflict could be the trigger for a period of slowbalisation where pace of global integration slows down.

5) Increased significance of TNCs :
   Reduction in transportation and communication costs along with capital market and trade liberalisation has allowed TNCs to take the advantage of offshoring and outsourcing. TNCs have entered new markets and invested significantly in expanding abroad to increase their sales revenues and profits.

6) Increase in the number and size of trading blocs :
   The number of regional trading blocs has increased significantly in the last 50 years. Trading blocs such as the EU, NAFTA and ASEAN are very active. The removal of trade barriers between the member countries has resulted in greater trade creation.

   Evaluation :
   With Brexit, more countries may leave the trading blocs in the future. Italy is considering exiting the European Union if Brexit proves to be beneficial to Britain in the next 5 years. There is also a possibility of Grexit.

Conclusion :
A combination of factors has increased globalisation over the last 50 years but perhaps, reduced cost of transport is most important as there has been a 1900 % increase in shipping container volumes between 1980 and 2020. Other factors like the global health crisis of 2020 is also important as it has disrupted global supply chains.

The benefits of Globalisation :

1) Increase in living standards :
   Free trade enables countries to specialise in accordance to their comparative advantage. This leads to an efficient allocation of global resources resulting in an increase in world GDP, economic growth and living standards.

2) Effect on consumers :
   Access to foreign goods means more consumer choice. Greater competition and firms enjoying economies of scale will lead to lower prices and increase consumer surplus.

3) Effect on producers :
   Global sourcing and large scale production have enabled firms to benefit from economies of scale lowering long run average costs. Access to global markets has resulted in higher sales revenue and increased profits.

4) Effect on developing economies :
   Developing countries are likely to benefit from job creation, transfer of technology and modern managerial techniques introduced by TNCs.

5) Reduction in poverty :
   Increased trade and higher growth rates have led to reductions in absolute poverty globally but developing nations have benefitted the most, particularly China and India.

6) Effect on governments :
   Higher profits of firms along with increased income and spending of individuals have resulted in more tax revenue for the government which can be spent on public sector services.

Costs of Globalisation :

1) Exploitation of workers :
   Globalisation has resulted into the exploitation of labour in developing countries due to weaker laws and regulations. TNCs often pay low wages, employ child labor and provide poor working conditions.

2) Environmental impact :
   Increased production and transportation has led to greater external costs through deforestation, carbon emissions and depletion of non-renewable resources, such as oil. This will make it harder for future generations to achieve sustainable economic growth.

3) Displaced workers :
   The transfer of much of manufacturing from Western Europe and the USA to low wage economies such as China has led to large scale job losses in developed countries. Globalisation has also resulted into a decline of traditional industries such as mining and steel creating structural unemployment. This may cause pressure on government budgets due to rising unemployment benefits.

4) Increased income inequality :
   Globalisation has been associated with rising income inequality between and also within countries. Demand for unskilled workers has fallen in developed countries leading to lower wage rates. Rise in global demand for skilled workers has increased their wages. This has widened the wage gap between skilled and unskilled workers.

5) Loss of tax revenue :
   High rates of tax avoidance through the misuse of transfer pricing by TNCs deprive governments of the tax revenues needed to finance essential public and merit goods.

6) Influence of TNCs in domestic economic policy :
   TNCs may lobby the government and influence economic policy decisions in their favour. Governments are often influenced by promises of large investments or threats of removing investment from their countries.

Conclusion :
In conclusion, the costs don't outweigh the benefits as there is an overall increase in world output, efficiency and standard of living.

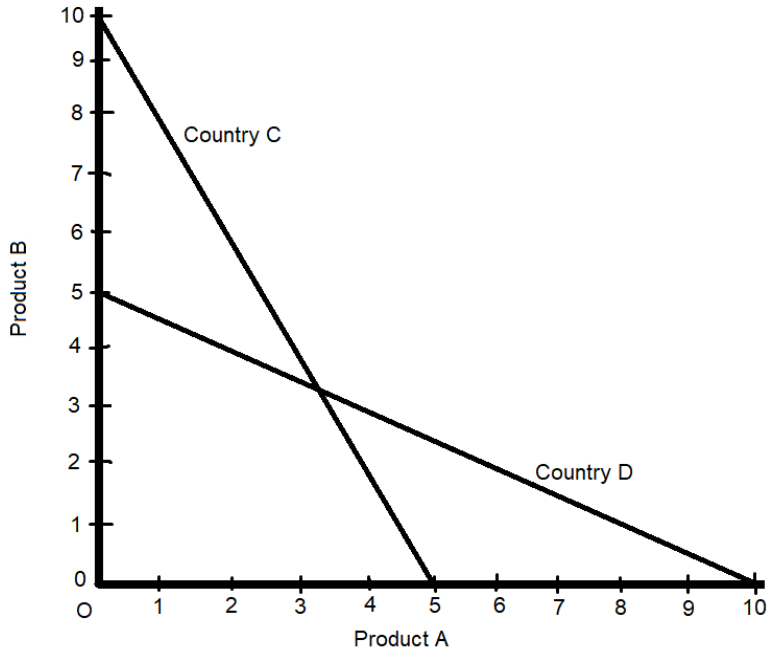
INTERNATIONAL TRADE

Absolute Advantage :
It is the ability to produce a good or service at a lower cost than another country.

Using all its resources;

	Cars		TV
Country A	40	or	20
Country B	20	or	40

Country A has an absolute advantage in the production of cars and will specialise on it.
Country B has an absolute advantage in the production of TV and will specialise on it.



Absolute Production Possibilities Curves

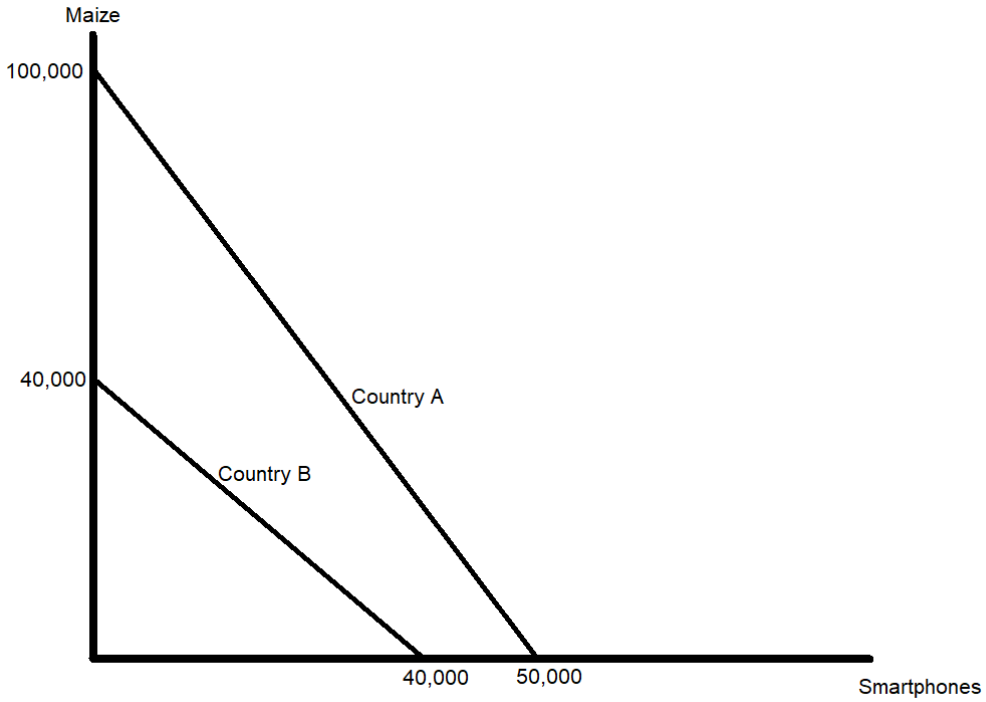
- Country C has absolute advantage for product B
- Country D has absolute advantage for product A

Comparative Advantage :
It is the ability to produce a good or service at a lower opportunity cost than another country.

Assume country A and B can both produce maize and smartphones. Their production possibilities are as follows.

	Maize		Smartphones
Country A	100,000	or	50,000
Country B	40,000	or	40,000

Country A has an absolute advantage in the production of both maize and smartphones.



To determine whether trade will be beneficial, the opportunity costs must be calculated.

	Opportunity cost of producing 1 kg of maize	Opportunity cost of producing 1 smartphone
Country A	0.5	2
Country B	1	1

- Country A has a comparative advantage in maize and thus will specialise in the production of maize.
- Country B has a comparative advantage in smartphones and thus will specialise in the production of smartphones.
- Therefore both countries will benefit from increased consumption after specialisation.

Note → If the opportunity costs were the same, then the countries would not benefit from specialisation and trade.

Limitations of the law of comparative advantage/Evaluation :

1) The law of comparative advantage is based on unrealistic assumptions such as constant costs of production, zero transport costs, perfect factor mobility and no barriers to trade. In reality such factors can influence trade decisions and volumes of trade.
2) It also does not take into account political influences and obligations of trade agreements.
3) Assumptions also include bilateral rather than multilateral trade and reciprocal demand. These assumptions may not exist in practice.
4) Free trade is not fair, i.e. the rich countries might exert their monopsony power to force producers in developing countries to accept low prices.

Terms of trade index :

$$\frac{\text{Index of export prices}}{\text{Index of import prices}} \times 100$$

Changes in the terms of trade :

- Deterioration of terms of trade :
  If import prices rise faster than export prices, then the terms of trade will deteriorate.

- Improvement in terms of trade :
  If export prices are rising faster than import prices, the terms of trade index will improve.

Impact of a fall in a country's terms of trade on a government's macroeconomic objectives :

1) Price of exports ↓ Export demand ↑; relative price of imports ↑ Import demand ↓ (X-M) ↑ This improves the trade balance, meeting the objective of balance of payments equilibrium on the current account.
2) Improvement in the trade balance as (X-M) ↑ AD ↑ GDP ↑ + unemployment ↓ particularly in the export industries
3) AD ↑ Demand-pull inflation ↑ if the economy is close to the full employment level
4) Price of imported raw materials ↑ cost-push inflationary pressures ↑
5) Unemployment ↓ budget balance improves as transfer payments falls and tax revenue rises
6) Higher rates of economic growth → external costs ↑ negative impact on the environment
7) Higher rates of economic growth → higher returns for the skilled and owners of the factors of production compared to the low skilled and those who do not own assets → income inequality ↑

Evaluation :

1) The balance of payments current account will only improve if the sum of the PED for exports and imports is greater than 1. i.e. the Marshall-Lerner condition is met.
2) The balance of payments current account may not improve if the income and current transfer component deteriorates.
3) Higher cost of imported raw materials will increase the costs of production and shift the SRAS to the left. This will result into lower GDP and offset the positive impact on economic growth.
4) Use of cleaner technology and renewable sources of energy such as solar and wind power may achieve growth without adversely affecting the environment.

Conclusion :

The overall impact depends on the level of spare capacity and the size of the multiplier.

TRADING BLOCS

A trading bloc is a group of countries that have signed a regional trade agreement to reduce or eliminate tariffs, quotas and other trade barriers between themselves. For example - ASEAN

Type of trading bloc :

1) Free Trade Area :
   Trade barriers are completely removed between member countries. For example - NAFTA

2) Customs Union :
   There is free trade between member countries and a common external tariff on imports from outside the bloc. For example - Economic Community of West African States (ECOWAS)

3) Common Market :
   Common markets are custom unions that also include the free movement of labour and capital between member countries. For example - EU

4) Monetary Unions :
   These are common markets that adopt a common currency and therefore operate a single monetary policy for the whole union. For example - Eurozone of the EU

Benefits of membership of a trading bloc :

1) Trade creation :
   Trade creation occurs as consumption shifts from a high cost producer to a low cost producer within the bloc due to the removal of trade barriers. This will increase trade within the bloc and countries will specialise as per their comparative advantage raising world output and living standards.

2) Economies of scale :
   Firms will have access to larger markets allowing them to increase sales and expand their customer base. They can raise production and benefit from economies of scale leading to lower LRAC.

3) Efficiency :
   Increased competition between firms may increase productivity as firms may find ways to become allocatively and productively efficient. Higher competition can increase innovation and lead to greater dynamic efficiency.

4) Economic growth :
   An increase in net exports will increase AD leading to higher real GDP and economic growth. Employment also increases since demand for labour is a derived demand. This will increase average incomes and reduce absolute poverty.

5) Consumer and producer surplus :
   Lower price of imports will increase consumer surplus along with a wider choice of goods and services of better quality. This will increase living standards. Firms who import raw materials will see a fall in production costs increasing producer surplus.

Costs of membership of a trading bloc :

1) Trade diversion :
   Trade diversion occurs when consumption shifts from low cost producers outside to high cost producers inside the bloc. This is due to imposition of tariffs on goods from outside the bloc. This will cause a decrease in specialisation and world output.

2) Decline of inefficient firms :
   Less efficient firms or infant industries may be driven out of the markets by powerful TNCs in other member countries. This can increase unemployment and inequality in the declining regions along with pressure on government finances.

3) Effect on current account :
   If imports exceed exports from the country then it will worsen the current account of the balance of payments.

4) Benefits depend on the type of goods traded :
   Benefits depend upon what goods are traded by the country. Countries specialising in primary products will have worsening terms of trade. Instead export of high value manufactured goods will develop the secondary industry and allow faster rates of growth.

Conclusion :
In the long term, the benefits of a trading bloc depend on the coordination between all member countries regarding trade policies.

Possible conflicts between trading blocs and the WTO :

1) WTO aims for free trade between its members. Regional trade agreements restrict trade with non-member countries which conflicts with the aims of WTO. Trading blocs fail to meet the WTO's most-favoured nation clause, which states a reduction in tariff for one country must be extended to all WTO member countries. This is because trading blocs remove tariffs between its members but impose tariffs on non-members.

2) WTO aims to settle trade disputes between member countries whereas trading blocs could create differences between member and non-member nations. This is because non-member nations face a wide range of difficulties such as limited access to markets, lower economic growth and a worsening trade balance.

3) The existence of trade blocs could offer countries an alternative to joining the WTO, or make WTO agreements less important for them.

4) Nevertheless, it may be agreed that the growth in both the number and size of trading blocs has contributed to the goal of promoting free trade.

MONETARY UNION

A monetary union is a group of two or more countries who share a common currency and thus a common monetary policy. Example : Eurozone of the EU

Advantages of Monetary union :

1) Elimination of transaction costs :
   Transactions costs are eliminated as firms and tourists will not have to pay the cost of converting currencies. This reduces the cost of trade and stimulates greater trade within the monetary union.

   Evaluation :
   However, these costs are insignificant as it takes up a very small proportion of GDP.

2) Price transparency :
   A single currency allows greater price transparency as consumers and producers can compare prices more easily across national borders. This will encourage greater trade amongst countries, increase consumer welfare and lower the chances of price discrimination.

Evaluation :
However, the existence of transportation costs, geographical barriers and asymmetric information will prevent this from happening.

3) Eliminates exchange rate fluctuations :
It eliminates exchange rate fluctuations between member countries as a common currency is being used by members. This increases business certainty and encourages investment and trade.

Disadvantages of a monetary union :

1) Loss of control over independent monetary policy :
Countries will have loss of control over independent monetary policy and will no longer be able to set their own interest rates which will rather be set by the common central bank. E.g. European Central Bank (ECB) for Eurozone
For example, lowering interest rates would help to bring the Greek economy out of recession whose debt to GDP ratio is 174%. However low interest rates could trigger spending and increase inflation rate in Germany. Therefore, this 'one size fits all' monetary policy is unlikely to be appropriate for all the member countries.

2) Loss of exchange rate flexibility against member nations :
Having the same currency reduces a country's ability to become more competitive by allowing its currency to depreciate.

3) Transition costs :
Transition costs are one-off costs associated with changing menus, price lists and vending machines when the new currency is introduced. In practice, these are relatively insignificant.

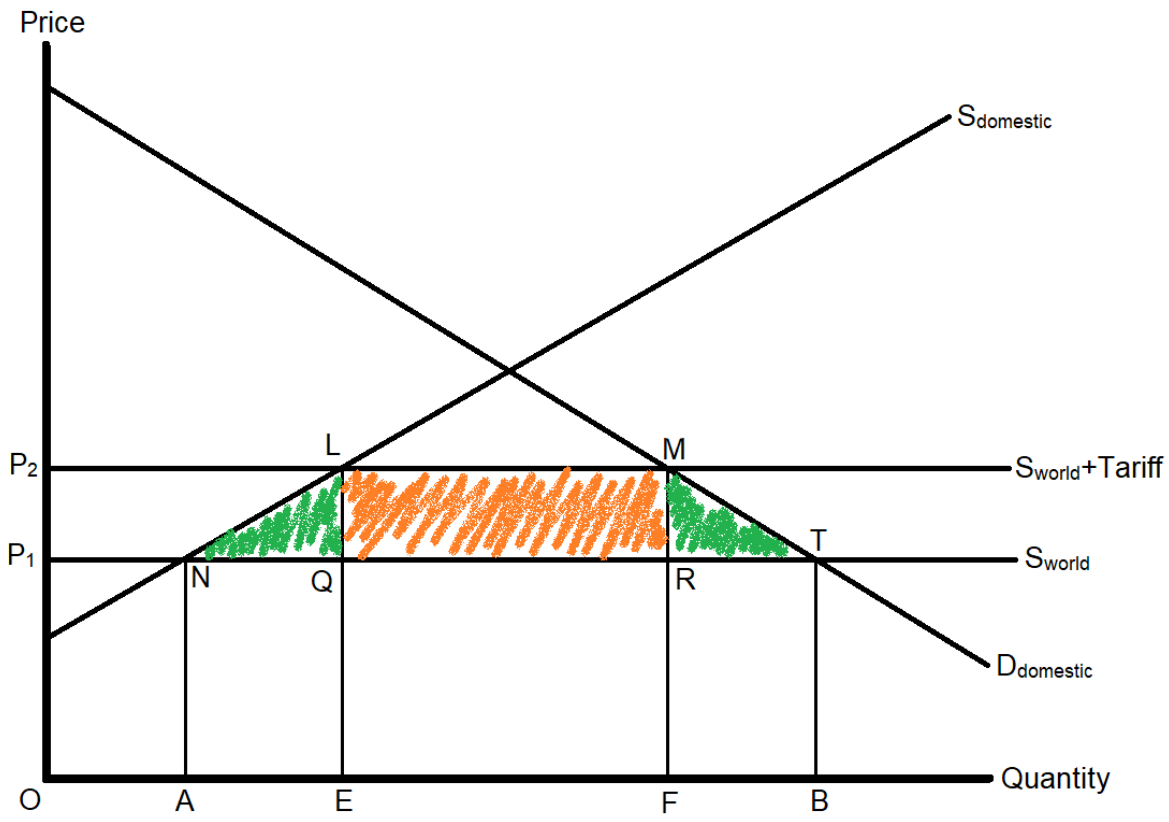
Conclusion :
Overall, the benefits of a monetary union are far more focused on the microeconomic side and the costs are more involved with macroeconomics. The recent Eurozone crisis highlights this.

PROTECTIONISM

Protectionism means restrictions on free trade.

Methods of protectionism :

1) Tariff :
   Tariff is an indirect tax imposed on imports. They restrict imports by making them expensive and encourage consumers to switch to domestic goods and services.



Before the tariff is imposed :

- The price paid by consumers is OP_1
- Domestic output is OA whereas domestic demand is OB
- Therefore AB units are imported

After the tariff is imposed :

- The price paid by consumers rises to OP_2, so reducing consumer surplus by P_1P_2MT
- Domestic output rises to OE, so increasing producer surplus by P_1P_2LN
- Imports fall to EF
- Tax revenue to the government is QLMR
- Net welfare loss is equivalent to NLQ and RMT

Evaluation :
Imposition of tariff may not be successful in reducing imports if the PED for imports is price inelastic and if the magnitude of tariff is low.

2) Quota :
It is a physical limitation on the level of imports. Since quotas limit the amount of imports available it results into higher prices and allows domestic producers to gain more business.

3) Subsidies to domestic producers :
Grants given to domestic producers to artificially lower their production cost and will enable them to be more competitive compared to imports.

4) Administrative barriers :
Administrative barriers include a wide range of alternative methods to restrict imports such as :
    - Health and safety regulations
    - Environmental regulations
    - Bureaucracy - making documentation process more difficult

   All these may raise the cost of imports and defer foreign companies from attempting to export goods to that country.

Arguments for protectionism :

1) Protect domestic employment :
Cheaper imports reduce jobs as domestic production would fall. Trade restrictions will lower imports leading to a rise in domestic output and unemployment.

2) To protect infant industries :
Infant industries need to be protected to give them time to expand and gain economies of scale so that they can be internationally competitive. Countries such as Japan and South Korea have successfully developed infant industries behind high trade barriers.

3) To correct current account deficits :
   Restrictions upon import may be imposed by a country to reduce current account deficit.

4) To prevent dumping :
   Trade barriers can prevent dumping of goods by overseas firms. Dumping refers to goods exported to another country at below average cost of production. It is a form of predatory pricing and can drive domestic firms out of the market.

5) To raise revenue :
   Governments of developing countries may impose tariffs in order to raise revenue which can be spent on various public services to improve standard of living.

6) To protect national security :
   Industries such as agriculture, steel, weapons may be of strategic importance to a country especially in times of conflict or crisis as supplies of imports may be cut off and they need to be protected.

Arguments against Protectionism :

1) Distorts comparative advantage :
   It distorts comparative advantage and reduces specialisation resulting into lower world output and therefore lower living standards.

2) Retaliation :
   It may encourage retaliation from other trading partners and further worsen the trade due to reduction in exports.

3) Inefficiency :
   Domestic firms may become inefficient due to lack of competition. Moreover, it is difficult for a government to decide which infant industries have potential comparative advantage. It may mean wasting financial resources if the industry is unable to gain economies of scale.

4) Inflation :
   Consumer welfare is reduced as such measures could lead to inflation due to higher prices and less choice thus reducing consumer surplus.

5) Conflict with WTO :
   Protectionist measures may breach international obligations such as those of the WTO. This can result into trade disputes.

   Conclusion :
   Overall the impact depends upon the size of the protectionist measure put in place and on how many goods the tariff applies to.

CHANGING PATTERNS OF WORLD TRADE

Factors influencing patterns of trade :

1) Emerging economies :
   Emerging economies are developing countries which are experiencing rapid economic growth rates. Some of them include China, India, Brazil, Russia, South Africa etc.

   Many emerging economies have cost advantages over advanced economies. The deindustrialization of countries such as the UK and USA has meant that their manufacturing sector has shifted to other countries, such as China.

   This has led to the industrialization of China & India. The volume of manufactured goods that they export and their share of world trade have increased.

   Rapidly growing economies in Asia tend to produce and export manufactured goods, whereas those in sub-Saharan Africa have a tendency to produce and export primary products.

   Overtime, developed economies have specialised more in the high tech secondary sector and service sector and tend to import more goods and export more services.

   Emerging economies are also likely to run trade surpluses and perhaps the more developed countries are likely to run trade deficits.

   For a long time, China has been running a trade surplus with the US.
   Trade patterns are also influenced by the FDI flow between countries. Emerging economies have received FDI inflows from developed countries, but equally FDI flows occur between emerging economies.

For example, China is investing in countries such as Kenya & Bangladesh - setting up factories to take advantage of cheap labour costs in these countries. This will increase export flows from these countries.

Evaluation :

1) Wage costs in emerging economies are going up and advances in technology which makes production more capital intensive means developed economies can increasingly manufacture goods locally rather than importing so much.

2) Some emerging economies such as Brazil and Russia have not been able to sustain the same rates of economic growth over the last decade as compared to China & India.

3) Use of protectionist measures can reduce trade between the nations. USA has been in a trade war with China and this has slowed the rate of economic growth of China significantly since 2017.

4) Moreover, developed countries are keen to reduce tariffs and remove subsidies on manufactured goods in which they have a comparative advantage but are reluctant to open their markets to goods in which developing countries have a comparative advantage.

2) Changes in comparative advantage :
A country can experience a change in its comparative advantage overtime. Most of the richest countries in Europe and North America have seen a comparative advantage shift from older industries, such as textiles, ship building and steel making towards services and high tech 'knowledge industries'.

Evaluation :
The theory is derived from a simple model with two countries; the global trade market is significantly more complex where countries produce a wide variety of goods and services and there is very little specialisation. This is helped by the advancement of technology.

3) Growth of trading blocs and bilateral trade agreements :
The growth of trading blocs and bilateral trade agreements has also influenced the pattern of trade. Trading blocs have led to trade creation between members, since there is free trade within the bloc. In NAFTA intra bloc trade is equivalent to 50%.

Evaluation :
However trade has been diverted from outside the bloc, since protectionist barriers are often imposed on countries who are not member countries.

4) Changes in relative exchange rate :
   Changes in relative exchange rates or currency manipulation by countries can influence trade patterns as they change prices of exports and imports. For example China has deliberately kept the value of Chinese Yuan (¥) lower against the US dollar ($) which makes Chinese goods more price competitive in the US markets.

5) Changes in protectionism between countries :
   Restrictions on free trade between countries affect trade flows between these countries. For example the current US-China trade war can reduce trade between these nations. Countries will be able to export more if other countries reduce tariff and non-tariff barriers.

EXCHANGE RATE

Exchange Rate :
The exchange rate is the price of one currency in terms of another currency.

Types of exchange rate systems :

1) Floating exchange rate :
   Exchange rate is determined by the market forces of demand & supply of the currency. Eg. Pound, Euro, Swedish Krona.

2) Fixed exchange rate :
   Government fixes the exchange rate against other major currencies. The target is maintained by changing interest rates or adjusting foreign currency reserves. Eg. Bahrain Dinar

3) Managed floating exchange rates :
   The price of the currency is largely determined by the market forces but the government may intervene from time to time to influence the exchange rate. Eg. Turkish Lira, Brazilian Real, Bangladeshi Taka

Changes in the exchange rate :

- Under a floating exchange rate system,
  → Appreciation of a currency means the value of one currency increasing in terms of another currency.
  → Depreciation of a currency means the value of one currency decreasing in terms of another currency.

- Under a fixed exchange rate system,
  → Revaluation : When the government fixes a higher exchange rate for the currency.
  → Devaluation : When the government fixes a lower exchange rate for the currency.

Government policies to stabilise the value of the currency :

1) Foreign currency transactions :
   - If the central bank wants to raise the value of its currency, it will buy its own currency in exchange for foreign currency. This increase in demand for the domestic currency would cause a rise in its value.
   - If the central bank wants to lower the value of its currency, it will sell its own currency on the foreign exchange market. This increase in supply of the domestic currency would cause a fall in its value.

2) Changes in the relative interest rates :
   If the central bank wishes to increase the value of the country's currency, it would raise interest rates. Higher interest rates relative to other countries will act as an incentive for foreigners to save in the country's banks. This hot money inflow will increase the demand for the currency in the foreign exchange market causing its value to rise.

3) Quantitative Easing :
   Quantitative easing is a monetary policy instrument where the central bank buys financial assets in exchange for money in order to increase borrowing and lending in the economy. This tends to increase the supply of money and would, therefore, tend to cause the value of a currency to depreciate against other currencies.

4) Policies to encourage or restrict the inflow of funds :
   For example, the government could take policies to restrict the FDI which will reduce the demand for the currency in the foreign exchange market and keep the currency value low.

Evaluation :

1) Changes in interest rates and the use of quantitative easing under monetary policy may conflict with macroeconomic objectives. For example lowering interest rates to weaken the currency can lead to demand-pull inflation through rising AD if the economy is close to the full employment level.

2) Currency manipulation is prohibited by the IMF and the WTO. Such manipulations could result into retaliation by other members if competitive devaluation is taken through government intervention. For example, the USA blaming China for currency manipulation to keep the value of Yuan (¥) low against the US Dollar ($).

3) Under a floating exchange rate system it would be difficult to achieve stability due to speculative activity which may offset government actions to alter the external value of the currency.

Factors that influence the exchange rate of a currency (floating) :

1) Relative interest rates :
   An increase in interest rates relative to other nations may lead to foreigners choosing to deposit their savings in the country due to higher return. This 'hot money inflow' will increase the demand for the currency and cause its value to rise.

   Evaluation :
   However, with the use of quantitative easing in many countries after the global financial crisis, it might play a more significant role now with its effects on increasing money supply.

2) Expectations and Speculation :
   If currency speculators expect that the value of the currency will rise then they will demand more of the country's currency causing the exchange rate to appreciate.

   Evaluation :
   In the short term speculation plays a very important role in the value of a currency. However, in the long term the value of a currency is determined by economic fundamentals such as exports, imports and long-term capital movements.

3) Relative inflation rates :
   If the country's inflation is higher than that of its major competitors then, according to purchasing power parity theory, exports will be less price competitive. Lower exports will reduce demand for the currency and reduce its value.

   Evaluation :
   However, small inflation rate differences might be offset by non-price factors such as high quality which could cause insignificant reduction in exports.

4) Current account of the balance of payments :
   A persistent deficit on the current account of the balance of payments means that the supply of currency is greater than its demand and the value of the currency is expected to fall.

   Evaluation :
   However, current account is only a part of the balance of payment account and other capital flows are also much more significant such as FDI, short-term capital flows. A surplus in the capital and financial account will suggest a rise in demand for the currency which can offset the declining value of the currency.

5) Capital flight :
   Capital flight is the rapid movement of large sums of money out of a country due to economic or political instability. Individuals and firms may invest in foreing assets where they expect to make higher returns. This increases the supply of the currency and causes the value of the currency to fall.

   Evaluation :
   However, tighter government restrictions on financial capital movements will reduce capital flight.

Impact of changes in exchange rate (Depreciation/Devaluation) :

1) The current account of the balance of payments :
   Depreciation of the currency will make exports relatively cheaper and imports relatively expensive. This will increase price competitiveness leading to a rise in exports and a fall in imports and thus improve the current account of the balance of payments.

   Evaluation :

   - Marshall-Lerner Condition :
     However, the current account of the balance of payments will only improve if the Marshall-Lerner condition is met where the sum of the PEDs for exports and imports is greater than 1

   - The J-curve effect :

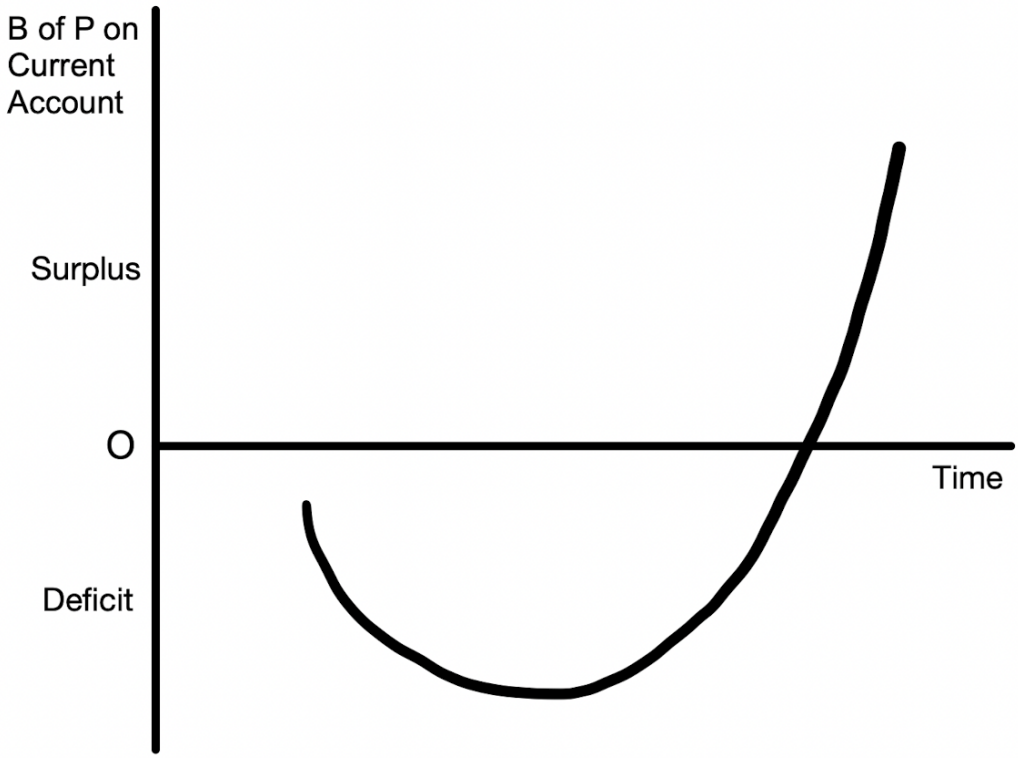


Fig : J-Curve

The J-curve effect explains that initially the current account will worsen since demand for exports and imports is price inelastic.

2) Economic growth :
   Depreciation increases the competitiveness of a country's goods and services. This should lead to an increase in aggregate demand because net exports will rise resulting in an increase in economic growth. This will improve living standards as average incomes rise.

   Evaluation :
   However, other components may offset the increase in AD and slow down growth rate; eg. fall in investment. The increase in real output also depends on the spare capacity and the size of the multiplier which will be bigger if MPC is high.

3) Unemployment :
   Competitive exports will create employment in the export oriented industries since demand for labour is a derived demand. Similarly, domestic employment increases as consumers switch away from expensive imports.

   Evaluation :
   However, the economy may still suffer from underemployment where individuals are highly skilled but work in low skill jobs.

4) Inflation :
   Higher prices of imported raw material inputs specially oil will result in cost-push inflation. An increase in net exports will also increase AD causing demand-pull inflation to increase.

   Evaluation :
   However, the effect will be larger for an economy which is a major importer of raw materials and is close to the full employment level. Similarly, prices may not rise if firm cut profit margins or if productivity rises.

5) FDI :
   Depreciation will make it cheaper for TNCs to invest in the country as they will get more currency in return when converted.

   Evaluation :
   However, there are other factors which can influence FDI decisions by firms. If there is economic and political instability and a declining exchange rate is due to poor economic performance then it will discourage FDI.

6) The capital & financial accounts of the balance of payments :
   More inward FDI flows and less outward FDI flows will improve the financial account position of the balance of payments.

   Conclusion :
   Overall the economic impact will largely depend on the extent of the depreciation of the currency and whether it is short or long term depreciation.

BALANCE OF PAYMENTS CURRENT ACCOUNT

Balance of Payments Account :
The balance of payments account is a record of all financial transactions between one country and other countries over the course of a year. It consists of the current account and the capital and financial account.

Components of the Balance of payments

A) The Current Account :
   - Trade in Goods
   - Trade in Services
   - Income : Net income flows (profits, dividends, interest)
   - Current Transfers : Remittance, foreign aid

Balance of trade = Value of goods & services exported - Value of goods & services imported

Current Account Balance :
It is the sum of trade in goods balance, trade in services balance and the balances on income and current transfers.

B) The Capital & Financial Account :
   - Foreign direct investment (FDI)
   - Portfolio investment in shares & bonds
   - Short-term capital flows : hot money flows

Balance payments = Current account balance + Capital & Financial account balance

Causes of surpluses on the current account (China, Germany, Saudi Arabia) :

1) Relatively low value of the country's currency :
   Some governments deliberately keep their exchange rates artificially low. This makes their exports seem relatively cheaper and imports expensive. Thus, higher exports and lower imports can then lead to surpluses on the current account. It has been argued that despite China's fast economic growth, the Chinese Yuan (¥) has been kept undervalued by China's Central Bank against the US Dollar ($).

   Evaluation :
   However, devaluation of the currency would only improve the current account of the balance of payments if the sum of the PED for exports and imports is greater than 1 and the Marshall-Lerner condition is met.

2) Price Competitiveness :
   A country whose goods are price competitive will see a rise in exports and a current account surplus.
   - Relative high productivity - Norway has a relatively high output per worker. This higher labour productivity gives them a cost advantage compared to other countries.
   - Relatively low unit labour cost - Chinese exports are relatively cheaper on the world market because China's large population drives down wages and therefore low unit labour costs.

   Evaluation :
   However, the situation may be offset by protectionist measures. The ongoing US-China trade war can hamper long term exports of China leading to an adverse effect on their current account surplus.

3) Non-price competitiveness :
   A high reputation regarding non-price factors such as quality and design can improve competitiveness of exports. Germany has developed expertise in luxury cars and high-end capital equipment.

4) Protectionist policies :
   A country may use protectionist policies such as tariff, quotas to reduce their dependence on imports. Such measures will make imports more expensive, reducing their demand and encouraging consumers to buy domestic goods.

Evaluation :

- Countries are unlikely to use protectionist measures as it would lead to a trade war with other economies.
- Furthermore, WTO agreements can prevent nations from using protectionist policies except under specific circumstances.

5) Natural resources :
   Countries may have an abundance of natural resources which are highly demanded by other countries. For example - Saudi Arabia has large oil deposits which can be exported to other nations after meeting their domestic requirements.

Conclusion :
Overall different nations are likely to have different reasons behind current account surpluses. Price competitiveness may be more important at times of recession.

Causes of deficit on the current account (UK,USA) :

1) Relatively high value of the country's currency :
   An appreciation of the currency will make exports less price competitive and imports cheaper resulting into a worsening trade balance if PED for exports and imports is elastic.

   Evaluation :
   Countries with a managed exchange rate may deliberately lower the value of its currency to make their goods internationally competitive. Such measures will offset a rising current account deficit.

2) High levels of income :
   A period of rapid economic growth could mean increased consumer spending on imports especially for countries with high marginal propensity to import.

   Evaluation :
   This could be a short-term factor as when economic growth rate falls, it will lower consumer confidence and they will reduce spending on imports. This could decrease the current account deficit again.

3) High relative inflation :
   Relatively high rates of domestic inflation compared to international competitors will reduce exports as they seem less price competitive. This can lead to a deficit on the current account.

   Evaluation :
   If inflation is similarly high or higher in countries from where the goods are imported then imports will fall and may compensate for the falling exports.

4) Economic state of trading partners :
   Recession or slow growth in export markets such as the EU and USA can reduce exports to them as foreigners have less income and buy fewer imports.

   Evaluation :
   If the deficits are easily financed by inflows on the financial account and take up a small proportion of GDP then that may not be a cause of concern.

5) Competitiveness :
   Lack of price and non-price competitiveness can result into a decline in exports and a rise in imports. This may occur if a country has relatively low labour productivity, high unit labour costs.

   Evaluation (case-based) :
   There is inadequate data to draw conclusions. The data provided is for one year only. The deficit may not be significant compared to previous years.

   Conclusion :
   Different factors are important for different countries. For example - UK has a current account deficit due to its low productivity whereas India is one of the fastest growing nations in the world.

Significance of large current account imbalances :

A) Large and persistent deficits can be a problem because :

1) Rise in unemployment :
   Declining exports and rising imports will increase unemployment as less labour will be demanded. There will also be a multiplied contraction of output in the economy as imports are withdrawal from the circular flow of income.

Evaluation :
However, if the unemployed is sufficiently occupationally and geographically mobile then they may switch to available jobs in the economy. This will reduce the economic consequences and burden on public finances in the form of unemployment benefits.

2) Currency Depreciation :
   Under a floating exchange rate, persistent current account deficit could lead to currency depreciation as the supply of currency in the foreign exchange market increases. This can increase inflationary pressures as raw material imports become more expensive.

   Evaluation :
   However as currency depreciates, exports become price competitive and this might bring about a correction of the deficit through rising exports if the Marshall-Lerner condition is fulfilled in the long run.

3) Decline in foreing currency reserves :
   A persistent and rising current account deficit might be a problem because there is a need to finance the increasing expenditure on imports. This could mean running down foreing currency reserves or the need to borrow from the IMF. Having large international debts can be problematic since they must be repaid along with interest.

   Evaluation :
   However, inflows into the financial account through FDI and portfolio investment have meant that this hasn't been a problem for countries such as the USA & UK.

4) Lower growth rates :
   It indicates a lack of competitiveness for the country. An uncompetitive manufacturing sector will lead to lower economic growth and a rise in unemployment in the long run.

Conclusion :
However, if imbalance is caused by import of capital goods then it will improve the productive potential of the economy in the long-run. Furthermore, if the deficits take up a small proportion of GDP then there may not be a cause of concern.

B) Large & persistent surplus can be a problem because :

1) Retaliation :
   This can imply that the country's trading partners are experiencing a current account deficit and they may impose protectionist measures such as tariffs and quotas.

   Evaluation :
   However, WTO agreements can prevent nations from using protectionist policies such as tariff and subsidies except under specific circumstances.

2) Currency Appreciation :
   Large surpluses might lead to currency appreciation. This can reduce future price competitiveness and lower exports. This can be a particular problem for developing countries seeking to diversify out of primary product production as it reduces price competitiveness of its manufactured exports.

   Evaluation :
   However, decline in exports will lower trade surplus and lead to self-correction of the balance of payments current account.

Measures to reduce imbalances on the current account :

A) Expenditure switching policies :

1) Policies to reduce imports - eg. tariff, quota
2) Policies to increase exports - eg. subsidies

Evaluation :
- Success depends on PED for exports and imports (elastic) and the magnitude (high)
- Retaliation
- WTO rules might prevent protectionism

3) Devaluation - Exports↑ Imports↓

Evaluation :
- Only be successful if Marshall-Lerner condition is met
- Can trigger cost-push inflation as cost of raw material imports rise

B) Expenditure Dampening policies :

1) Income taxes↑ Imports↓
2) Interest rates↑ Imports↓

Evaluation :

- AD↓ → Economic growth↓ → Unemployment↑
- Will only be effective if marginal propensity to import is high

C) Supply side policy : These policies will aim to boost productivity and so lower unit labour costs.

1) Spending on education and training to improve human capital
2) Spending on R&D to improve quality and design

Evaluation :

- Time lag
- Increase fiscal deficit and public sector net debt (PSND)

POVERTY & INEQUALITY

Absolute Poverty :
Absolute poverty means that a person does not have the sufficient resources to meet basic needs. Eg. food shelter, water, clothing.

It is measured as those living on less than US $1.90 a day at 2011 PPP (International poverty line set by World Bank)

Relative Poverty :
When an individual earns less than 60 % of the median income of the country they live in.

It is a situation where individuals lack the minimum amount of income needed in order to maintain the average standard of living in the country in which they live.

Inequality :
Income inequality refers to the unequal distribution of income between individuals.
Inequality is measured using the Lorenz curve and Gini Coefficient.

Wealth inequality refers to the differences in the value of stock of assets owned by individuals.
The richest 1% now has as much wealth as the rest of the world combined, according to Oxfam.

Causes of income inequality within countries :

1) Globalisation :
   Globalisation has led to a fall in demand for unskilled workers in advanced nations as manufacturing jobs have shifted to low wage economies such as China & Vietnam. Immigration of unskilled labour in some economies also puts downward pressure on wages for those on low incomes. In contrast, skilled workers are likely to earn higher wages as there will be a rise in global demand for their services. This has widened the wage gap between skilled and unskilled workers in advanced economies.

   Evaluation :
   Globalisation may encourage governments to raise spending on education and training. As human capital rises, unemployment could decline and income inequality would reduce significantly.

2) Education & Training :
   Differences in access to education and training can lead to wage differentials and rising income inequality. Workers with high levels of qualifications and skills such as pilots are high in demand but inelastic in supply and so they earn higher wages. In contrast, those with low qualifications and skills such as cleaners will find themselves in low paid jobs or even unemployed.

   Evaluation :
   Despite higher levels of education some workers may still suffer from lower earnings due to gender and age discrimination in the labour market. eg. women and younger people.

3) Type of employment :
   High growth tertiary industries such as IT and financial services have enjoyed above average increases in earnings. Entrepreneurs and shareholders in these industries benefit from higher profits. Income gap between rural and urban areas also increases as industrialization takes place.

Evaluation :
Income inequality may be reduced by increasing progressive income tax rates where the richer pay a larger proportion of their income. In the UK, those earning above £150,000 are charged a marginal tax rate of 45%.

4) Tax & Welfare benefits :
   A reduction in progressive income tax and an increase in regressive indirect taxes along with cuts to welfare payments will increase income inequality. Developing economies such as Bangladesh often have higher income inequality because their tax systems are underdeveloped and governments cannot afford an extensive welfare system.

   Evaluation :
   However, lower income tax rate raises the incentive to work and increases labour productivity. This can increase long run growth potential leading to economic growth and create future job opportunities for those on low incomes.

5) Automation :
   Technological change has made the skills of workers in certain industries obsolete leading to structural unemployment. Fewer secretaries, typists or assembly line workers are needed as computers and automation has replaced them in the production process.

   Evaluation :
   However, newer technology can increase the demand for the services of certain professionals, engineers who can service those machines.

Causes of income inequality between countries :

1) Differences in resource endowment :
   Countries with high resource endowment can produce more than others and this can increase income inequality between countries. Countries specialising in commodities may have a lower income than those specialising in manufacturing. This is because when income increases, demand for commodities will increase very little as they have relatively low YED compared to manufactured goods.

   Evaluation :
   Since commodities have low YED, a country exporting commodities will feel less impact when global income falls. Therefore, income inequality may actually decrease and terms of trade of the country exporting commodities may improve.

2) Differences in infrastructure :
   Differences in development of infrastructure is a likely reason for income inequality between countries. Countries with well developed infrastructure like airports, ports and roads can engage in more international trade, attract FDI and therefore see a higher income. Poor infrastructure in Sub-Saharan African countries like Ethiopia adds around 30% to 40% costs to the final price.

   Evaluation :
   However, a country rich in natural resources demanded by other countries might benefit from FDI; TNCs might provide some infrastructure to the country in order to facilitate its business investment.

3) Civil war, corruption & poor governance :
   Civil wars such as those that are occurring in Syria can disrupt growth and development. Developing nations may suffer from corruption which can increase costs for business. Furthermore, poor governance implies that the rulers of a country have adopted policies that result in the country's resources being allocated inefficiently. All these can reduce growth rates and incomes of the people living in these countries.

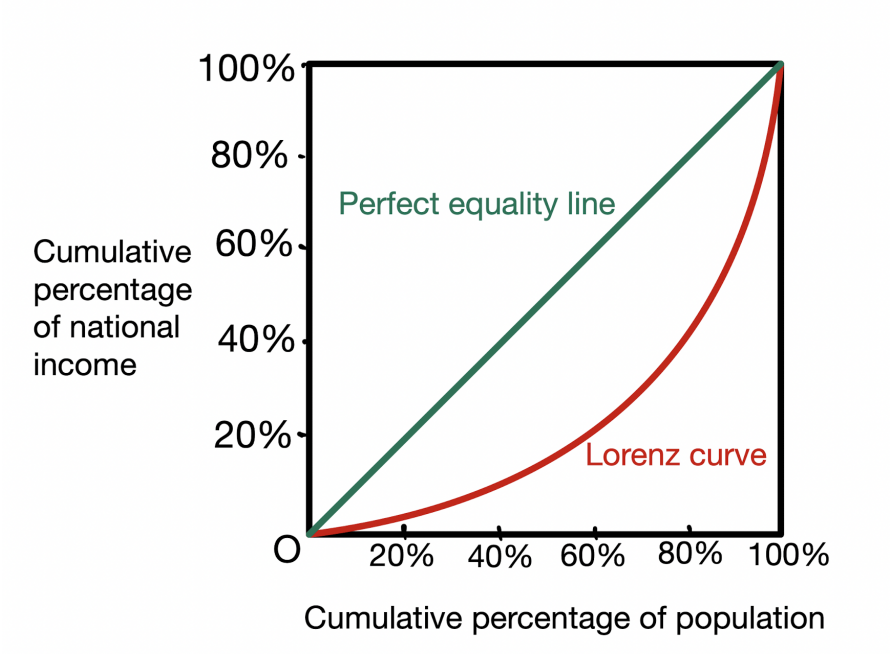
   Evaluation :
   Difference economies are likely to have different reasons which act as a constraint on growth rates and lead to rising income inequality. But the issue of corruption and poor governance is likely to be a problem for most developing countries.

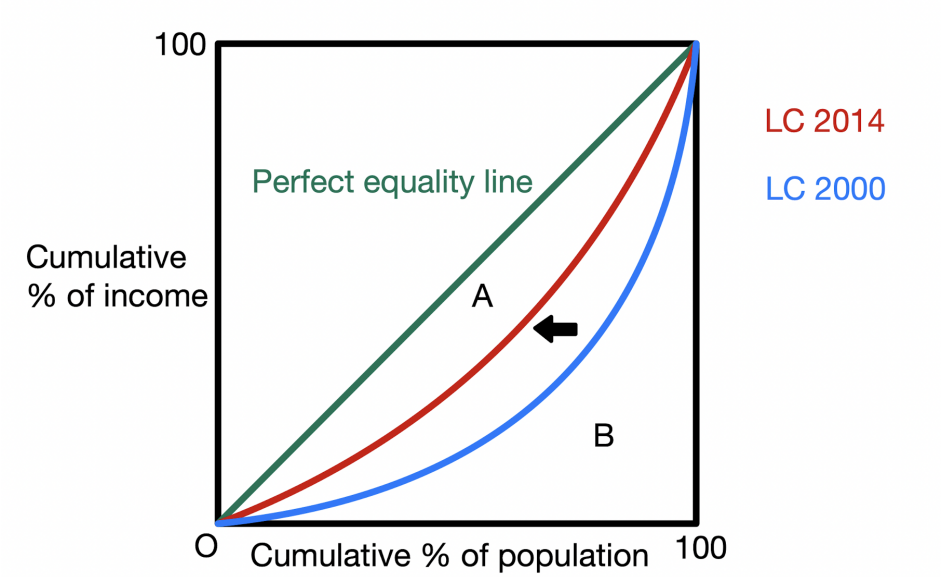
4) Education & Training [In context of differences in education & training resulting into different wages between the countries]

   Conclusion :
   Perhaps the most important factor for income inequality is differences in education and qualifications. People with better qualifications can earn higher income not only in developed countries but also in developing countries.

Measurements of Inequality :

The Lorenz curve :
The Lorenz curve plots the cumulative percentage of the population against the cumulative percentage of national income.





- The Lorenz Curve represents an unequal distribution of income.
- The further the Lorenz Curve is from the perfect equality line, the more unequal is the distribution of income.

The Gini Coefficient :
The Gini coefficient is a statistical measure of income inequality where the value ranges from 0 to 1.
The higher the Gini Coefficient, the greater the income inequality.

$$\text{Gini Coefficient} = \frac{A}{A+B}$$

Data (2020) :
Namibia : 0.597

Impact of an increase in income inequality :

1) Absolute poverty could remain high in countries where inequality is high. This could lead to less access to education which can lower human capital and long run productive potential of the economy.
   Similarly, there might be a reduction in the life expectancy due to lack of affordability of healthcare service.

2) A reduction in incomes could lead to a fall in the economy's MPC and hence consumption and aggregate demand are likely to fall. This can slow down economic growth and increase unemployment.

3) This can worsen public sector finances and further worsen inequality as fewer funds will be available for welfare benefits.

4) Consumption of imported goods may also fall and reduce the trade deficit.

5) A decrease in AD may also lower inflationary pressures.

6) Increase in poverty can lead to a rise in crime rates.

7) It can increase emigration from the country as people will seek jobs in nations with higher income.

8) Diagram shifting AD to the left.

Evaluation :

1) Those on higher incomes have a high MPC. Higher savings ratio in the economy may reduce a savings gap, increase investment and hence potential economic growth.

2) Deterioration in the quality of human capital and life expectancy will only be visible in the long-term after a significant time lag.

3) The decline in inflationary pressures will be greater if the economy is operating at the full employment level instead of spare capacity.

POLICIES TO REDUCE INEQUALITY

1) Tax reforms

- Direct taxes :
  Government may employ a more progressive income tax system where richer people pay a greater proportion of income as tax. This can be done by introducing more tax bands. For example- the UK has three income tax bands; 20%, 40% and 45%. This will lower the income of the high earners and reduce income inequality.
  Similarly, tax free allowances must be increased so that the lower income people can allocate most of their income for consumption. The UK increased the tax free allowance to £12,500 for the year 2020.

  Evaluation :
  - Higher rates of income tax may act as a disincentive to work and reduce the productive potential of the economy. Moreover, tax revenues may fall if they are too high as per the Laffer curve effect.
  - It may lead to more tax evasion, tax avoidance and may cause an increase in the number of tax exiles.

- Indirect taxes :
  Government must reduce indirect taxes as they are regressive, meaning lower income groups pay a greater proportion of their income as tax than the rich.
  The standard rate of VAT in the UK is 20% which is too high and the burden of tax falls more on low income earners.

Evaluation :
This might lower the funds available for spending on measures which could reduce inequality such as welfare benefits.

2) Increasing welfare benefits :
The government must increase the amount and the range of welfare payments for those who do not have the income to support their needs. For example - unemployment benefit, housing benefit, pension etc.

Evaluation :
Generous welfare payments can discourage the unemployed to look for work. If benefits don't rise in line with inflation, then people will receive less in real terms and may not be benefitted.

3) Increasing expenditure on education & training :
Governments must improve the quality and access to education for all. This will enable those without qualifications to increase their skills. A better educated individual has a higher chance of gaining employment and therefore earnings.

Evaluation :
However, there is considerable time lag for this to take effect and much depends on the quality of education. Furthermore, this policy might have a relatively insignificant effect in developed countries, as provision is already extensive.

4) National Minimum Wage :
The introduction of a national minimum wage and a series of increases in its value would prevent low paid workers from being exploited as they will receive a legal minimum wage per hour.
The current NMW is £8.20 per hour (2019) in the UK which increased from £7.50 in 2017.

Evaluation :
However, an increase in the NMW might result in higher unemployment as firms will demand less workers since labour costs will rise. This can increase inequality.

5) Policies to reduce unemployment :
   Unemployment is a major cause of poverty and inequality. Unemployment can be reduced by government sponsored job creation schemes, a fiscal stimulus such as reduction in taxes to increase AD or improving the mobility of labour.

   Evaluation :
   However, such schemes increase the expenditure of the government resulting into budget deficit, higher PSND and greater opportunity cost.

PUBLIC EXPENDITURE

Types of public expenditure :

1) Current expenditure :
   Day-to-day expenditure on goods and services, eg. salaries of teachers, medicines used by the hospitals.

2) Capital expenditure :
   Expenditure on long-term investment projects such as new hospitals and roads.

3) Transfer payments :
   Welfare payments made by the state to individuals for which there is no corresponding output, Eg. unemployment benefits and state pensions.

Factors influencing the size and pattern of public expenditure :

1) Changing expectations :
   As income increases, citizens will demand higher quality goods and services from the state. The demand for many public services such as health and education is income elastic. Therefore as incomes rise, the demand for these services rises more than proportionately.

2) Increase in size of the population :
   Countries with a rapid population growth rate such as Indonesia will need to spend more on education, healthcare and vaccination programs. Similarly an increase in the size of the population; eg. through immigration is likely to place extra pressure on public services such as schools, housing, transport etc.

Evaluation :
However, if the population of the working age increases, then GDP will rise and the government will receive higher tax revenue which can ease the pressure on public finances.

3) Ageing population :
   Most countries in Europe and Japan are facing an ageing population. An ageing population places a greater burden on the state because it may require greater public spending on state pensions, healthcare and social care.

   Evaluation :
   However, an ageing population would imply that less spending is required on education and healthcare for children. So even though expenditure may rise in one area, there may be falling spending in other areas.

4) Debt interest :
   If the national debt has increased then in subsequent years the government will be paying larger and larger amounts in interest payments, increasing public expenditure. The public sector net debt for the UK economy stood at £1.82 trillion in 2019, the debt interest for which was £41.6 billion.

   Evaluation :
   Interest payments depend on the interest rate as well as the amount owing. If the government is able to reduce the amount owing with less new borrowing then debt interest payments will decrease over time.

5) Discretionary Fiscal policy :
   Governments may provide a fiscal stimulus to their economies at times of recession to speedup economic recovery. The British government gave £500 billion rescue packages to the banks following the 2008 financial crisis. Similarly, due to automatic stabilisers, expenditures on welfare payments will also rise.

   Evaluation :
   This will be less true for low-income economies which have a very limited state welfare. Furthermore, the increase in public expenditure would be short-term if the economy is on its way to recovery.

Economic effects of a reduction in public expenditure as a proportion of GDP :

1) If public expenditure on infrastructure/education/healthcare↓ → productive potential of the economy↓ → LRAS↓

2) Government spending is a component of AD and an injection into the circular flow of income; if public expenditure↓ → less output and employment → negative multiplier → economic growth↓

3) Since GDP↓ → demand for labour↓ → unemployment↑ → average incomes↓

4) Austerity measures (transfer payments↓) → income inequality↑

5) Lower quality/quantity of public services → less access to these goods → standard of living↓

6) Less financial and resource crowding out as the government will not have to finance its spending through borrowing, and there will be more factors of production available to the private sector.

7) Inflationary pressures likely to be low as AD decreases

8) Improvement in government budget balance due to less borrowing required → provides funds to repay national debt

Evaluation :

1) If the economy is already at spare capacity, then the decline in real output and employment would be more significant compared to the decline in inflation.

2) The government budget balance may not improve if tax revenues also fall for that time period.

3) Lower government spending on welfare payments such as unemployment benefits could increase incentive to work and lower unemployment in the economy.

4) Size of the multiplier effect (explain)

Taxation

Direct tax :
A direct tax is a tax levied on income and wealth and the tax burden cannot be passed on to anyone else. Eg. income tax, corporate tax, inheritance tax.

Indirect tax :
An indirect tax is a tax levied on expenditure on goods and services. Eg. VAT, excise duties.

Categories of taxes :

- Progressive tax :
  As income rises, a greater proportion of income is paid as tax.

- Regressive tax :
  As income rises, a smaller proportion of income is paid as tax.

- Proportional tax :
  The same proportion of income is paid in tax, no matter what the level of income.

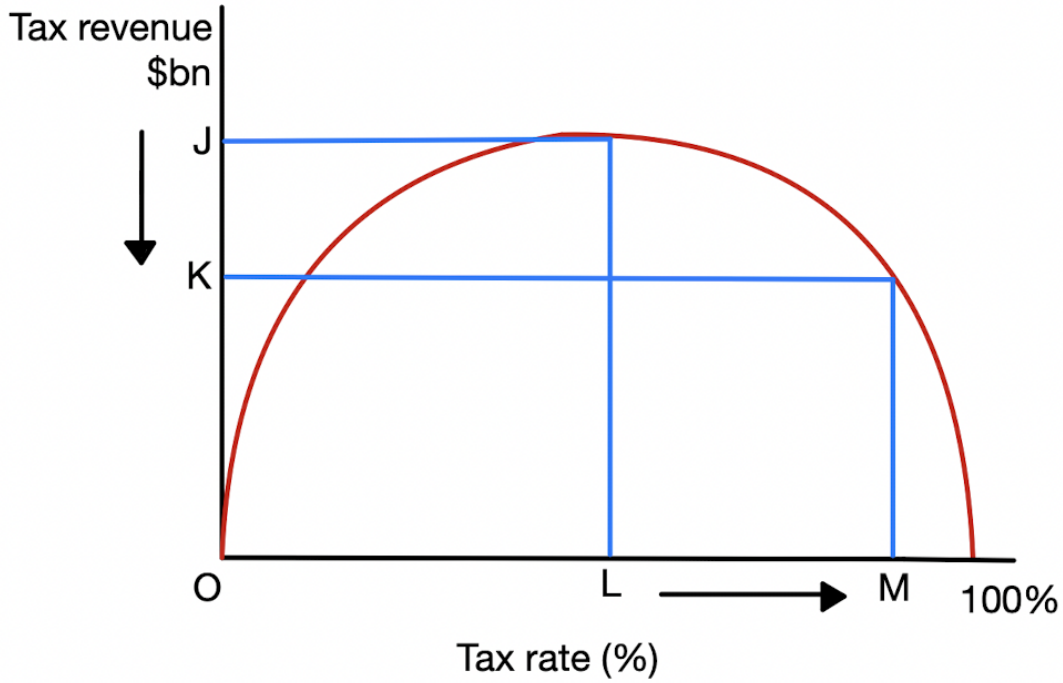
Impact of an increase in marginal income tax rates :

- A marginal tax rate is the rate at which tax is incurred on an additional dollar of income.

1) Impact on incentives to work :
   Higher income tax rates could act as disincentive to take higher paid jobs as higher incomes would mean higher tax payments.
   Similarly, people may be less willing to do overtime and reduce their working hours.

   Evaluation :
   Some workers might choose to work harder to ensure take home pay after paying taxes is enough to maintain their living standards.

2) Tax revenue :
   An increase in income tax rates will increase the tax revenues upto a certain point depending upon the tax rate. In the Laffer curve below, it can be seen that tax revenue is maximised at marginal tax rate L.



Laffer curve

Evaluation :
However, if tax rates are increased too much, tax revenues may actually fall. This is because less labour may be supplied due to disincentive effects. On the Laffer curve above, an increase in the tax rate from L to M causes a fall in tax revenue from J to K. The reduction in tax revenues also depends on the number of people affected by the changes in tax rates.

3) Tax avoidance, evasion & exile :
If the higher rate of income tax is increased, there is likely to be an increase in tax avoidance (legal) and tax evasion (illegal) and a rise in the number of tax exiles. Tax avoidance is the use of illegal methods to minimise the amount of income tax owed. Tax evasion happens when people intentionally do not pay taxes to the taxing authority and is illegal. Tax exile is when for example; a US citizen chooses to move to Costa Rica to avoid paying high taxes in the USA.

Evaluation :
If the tax authorities lack the skills and administrative resources to investigate and take actions against tax evasion and tax avoidance, then its occurrence rate will be high.

4) Income distribution :
   Direct taxes are progressive and so those on higher incomes pay a larger proportion of income as tax. If the taxes collected are used to redistribute incomes to the poor, then inequality will be reduced.

   Evaluation :
   High income taxes may fail to reduce income inequality if the government also chooses to increase indirect taxes which have regressive effects.

5) Real output & employment :
   An increase in taxes will reduce AD because taxes are a withdrawal from the circular flow of income. In turn, this might reduce real output and increase unemployment.

Impact of an increase in indirect taxes :

1) Income distribution :
   Indirect taxes are regressive where the lower income group pays a higher proportion of income as taxes than the rich. Those on lower income would face difficulty to buy necessities such as food and energy lowering living standards. Higher indirect taxes will therefore increase income inequality.

   Evaluation :
   If the VAT is increased on luxury items bought by the rich instead of necessities then the impact on inequality will be lower.Similarly, living standards may not fall if wages rise faster than prices.

2) Inflation :
   Higher prices due to indirect taxes can lead to workers and trade unions demanding for wage increases to compensate for the price rise. This wage-price spiral could result into cost-push inflation.

   Evaluation :
   The ability of workers to demand higher wages depends on their bargaining power. Skilled workers and workers who belong to strong trade unions have more bargaining power comparatively.

3) Incentives to work :
   A higher VAT rate would cause a fall in real incomes and increase incentives to work as wages earned can no longer buy the same amount of goods and services.

   Evaluation :
   Impact on incentives to work tend to be more significant when income tax rates are changed as it reduces disposable income directly.

4) Tax revenues :
   Raising indirect taxes would increase the tax revenue of the government. This can improve public finances by reducing the budget deficit.

   Evaluation :
   However tax revenues will only increase if the product or services have price inelastic demand. Eg. tobacco, fuel.

5) Real Output & Employment :
   An increase in taxes will reduce AD because taxes are a withdrawal from the circular flow of income. In turn, this might reduce real output increasing unemployment. It can also increase costs for businesses shifting the SRAS to the left, reducing output further.

   Evaluation :
   Other components of AD may not be equal. If there is a rise in injections such as exports or investment, it will increase AD leading to a rise in real output.

PUBLIC SECTOR NET BORROWING & DEBT

Public sector net borrowing/Fiscal Deficit :
Public sector net borrowing (PSNB) implies that government expenditure is greater than tax revenues.

Automatic stabilisers :
Automatic stabilisers include those changes in taxes and government spending that comes about automatically in line with the changes in GDP to reduce fluctuations caused by the business cycle.
Example : Progressive taxation reduces spending at times of economic growth while welfare payments stimulate spending during recession.

Discretionary Fiscal Policy :
It refers to deliberate changes in taxes and government expenditure to influence the economy. Eg. the government may decide to increase infrastructure spending.

Cyclical Fiscal deficit :
A cyclical fiscal deficit occurs during a recession in the economy because tax revenues will be falling and government expenditure (like welfare payments) will be increasing. Cyclical deficit is not regarded as a serious problem as it is likely to be temporary and may be necessary to generate economic growth during a period of economic decline.

Structural fiscal deficit :
A structural fiscal deficit remains even when the economy is operating at its full potential.
Structural deficits are major concerns for economies if they are persistent and take up a larger proportion of GDP. This would imply continuous fiscal deficits and an increasing national debt. This might be unsustainable as the government may have to find new sources of funds and may require tax rises and cuts in public expenditure.

Public sector net debt/National Debt :
Public sector net debt (PSND) is the cumulative total of past government borrowing. The national debt of Greece is 181% of GDP.

Consequences of large PSND :

1) Debt Servicing :
   An increase in national debt means the government has to pay higher interest payments each year. The opportunity cost of debt interest is that the money could have been used in providing more public services.

   Evaluation :
   If deficit spending is being used to finance improvements in education, infrastructure then it would increase the growth potential of the economy making it easier to repay debts in the future.

2) Crowding out :
   Higher public sector spending can lead to crowding out of private sector investment. Resource crowding out occurs when the economy is operating at full employment and the expansion of the public sector leaves less resources available for the private sector.
   Financial crowding out occurs as increased government borrowing to finance public spending drives up interest rates and reduces private sector investment.

Evaluation :
As current interest rates in most countries are low and globalisation has led to liberalisation of international capital markets, financial crowding out may not be a significant issue.

3) Downgrading of a country's credit rating :
   Concerns over the ability of a country to repay its debts in the future may lead to credit rating agencies downgrading a country's credit rating from AAA. This will lower confidence and discourage investors from buying government bonds. Government may have to offer higher interest rates on bonds which increase future borrowing costs.

4) Intergenerational equity :
   Increasing national debt also raises concerns over intergenerational equity. This is because one generation may receive the benefit of government programs enabled by deficit spending, but the resulting higher debt means future generations will bear the costs of repaying the debt.

5) Rising national debts may lead to loss of confidence in the currency and that may cause a fall in its value.

6) If the debt to GDP ratio is too high then countries may be forced to seek assistance from international organisations and other countries; eg. the IMF or the ECB in case of eurozone countries.

Evaluation :
National debt will be less of a concern if the fiscal deficits are cyclical and short term rather than structural and unsustainable.

Conclusion :
Overall, the impact on the economy will be greater if the national debt takes a larger percentage of GDP (refer to data from case to comment on significance).

MEASURES OF ECONOMIC DEVELOPMENT

The Human Development Index (HDI) :
The HDI represents a broader definition of well-being and provides a composite measure of three basic dimensions of human development; income, health and education.

The indicators include :

- Health : Life expectancy at birth

- Education : Mean of years of schooling for adults aged 25 years and expected years of schooling for children of school entering age

- Income : GNI per capita (PPP $)

Data :

HDI Rankings	Country	HDI Value
1	Norway	0.953
2	Switzerland	0.944
188	Central African Republic	0.367
189	Niger	0.354

Benefits of using HDI :

1) The advantages of HDI is that it combines the effects of increased growth with other quality of life indicators such as education and health and in that respect is an important measure of development.

2) It also takes income into account but qualifies income in terms of the cost of living since it is measured using GNI per capita (PPP$)

3) It is measured on a scale of 0-1 where 0 means least development and 1 means most development. Countries are given rankings according to the index, thus making it easier to see which countries are performing well and can help to identify countries that are in most need of development aid.

4) It is a consistent methodology used by the United Nations.

5) Improvement in education and healthcare index will suggest a decline in the number of people living in absolute poverty and will also contribute to better human capital in the long run promoting growth and development.

Evaluation :

1) HDI does not take into account many aspects of economic and social life that could be regarded as contributing to or constraining development. These include crime rates, corruption, external costs, working hours and working conditions.

2) HDI does not give any indication of the distribution of income.

3) Data collected to measure HDI may not be reliable. Some countries may deliberately produce misleading data. Furthermore in developing countries, there may be lack of availability of data or less up to date data.

4) Other measures, such as access to the internet might be more useful as it might be regarded by many as a freedom which improves the quality of people's lives.

Other measures of development :

- Mobile phones per thousand of the population
- Access to clean water
- The percentage of adult male labour in agriculture

CONSTRAINTS ON GROWTH & DEVELOPMENT

1) Primary product dependency :
Many countries, particularly in Sub-Saharan Africa are still dependent on primary products as a means of income and employment. For example, Cocoa is the chief agricultural export of Ghana. In Mozambique, around 80 % of the workforce is employed in agriculture.

a) Falling terms of trade :
The Prebisch-Singer hypothesis states that the terms of trade between primary products and manufactured goods tend to deteriorate overtime, since primary products are income inelastic. As global incomes rise, the price of manufactured goods increases more rapidly compared to primary goods as they have income elastic demand. Thus a developing country will have to export more to gain a given quantity of imports.

Evaluation :
Some countries have developed on the basis of their primary products which have income elastic demand, Botswana for diamonds. Although income elastic demand makes producers more vulnerable to world recessions.

b) Volatility of commodity prices :
Commodities have price inelastic demand and supply which results in price instability. This leads to fluctuating foreign currency earnings and fluctuating revenue of the producers. This uncertainty will lower investment.

Evaluation :
However, a forward contract may be used to offset the risk of price fluctuations by setting a predictable price and thus making planning decisions easier for both parties.

c) Appreciation of the currency :
Discovery of natural resources will increase the demand for a particular commodity and cause the country's currency to appreciate. This may reduce the competitiveness of the country's manufactured exports and lead to a decline in the manufacturing industry as explained by the Dutch disease.

Evaluation :
However, a strong exchange rate would make import of capital goods cheaper which can increase the long run productive potential of an economy.

d) Finite supplies of hard commodities :
Eventually supplies of hard commodities such as copper or gold will be exhausted so it is important that there be some diversification into other industries before that happens.

Evaluation :
However, the country may use the income gained from these products to diversify. Dubai has relatively less oil reserves, but has used the export revenue to diversify into tourism.

2) Savings gap :
   High levels of savings are important for growth and development. The Harrod-Domar model illustrates the problem of how developing countries with low GDP per capita will experience a low savings ratio as the poor are unable to sacrifice current consumption in order to make savings.
   This limits the funds available for investment, thus preventing economic growth and trapping countries in poverty. In Mozambique, 20% of the population has access to financial services.

   Evaluation :
   External finance can bridge the savings gap in developing countries. This includes foreign aid, FDI by TNCs and borrowing from international capital markets.

3) Foreign currency gap :
   Developing countries may face shortages of foreign currency. This may be caused by :
   - Dependency on the export earnings of primary products which according to the Prebisch-Singer hypothesis will result in lower terms of trade.
   - Interest payments on debt to foreign countries
   - Capital flight - This occurs when individuals or companies place deposits in foreign banks or buy assets in foreign countries.

   These factors could limit development because the country would have insufficient foreign currency to purchase imported capital goods and resources which might be needed to increase productive capacity.

   Evaluation :
   - However, income gained from primary product export may be used to diversify into other manufacturing sectors which can reduce the pressure on foreign currency needs.
   - Foreing exchange gap could be offset by debt cancellation provided to the poorest nations.

4) Debt :
   Many of the world's poorest countries such as Eritrea, Mozambique are struggling with high levels of external debt owed to all or some of the following - IMF, World Bank, governments and banks in developed countries.

   - The problem is that debt servicing may account for a large proportion of export earnings.
   - As of 2019, total external debt of low and middle-income countries is $7.8 trillion.

Evaluation :

- However, under the HIPC initiative, the World Bank and IMF have relieved 37 participating countries of more than $100 billion in debt.
- Moreover, if the borrowed money is spent on capital goods, it could lead to economic growth making it easier to pay off the debt if interest rates are low.

5) Corruption :

Corruption is the use of power for personal gain and it may take various forms including bribery, extortion and diversion of resources to the governing elite.
Corruption can cause an inefficient allocation of resources where contracts may be awarded on the basis of non-market criteria.
Similarly, money intended for public sector investment may be diverted to personal bank accounts. Furthermore, it increases costs of doing business in the country and discourages FDI.
All the above would result in a slower rate of economic growth and act as a constraint on economic development.

- Nigeria 1960-1999 leaders stole $400 billion, despite being resource rich.
- Somalia is the most corrupt country in the world

Evaluation :
However, corruption can slowly be solved through cultural changes and is not an easy fix. Exercising greater democracy might reduce corruption. Countries such as Liberia and Kosovo have shown remarkable success in dealing with public corruption and other governments could follow these measures.

6) Poor governance :

Poor governance implies that the rulers of the country have adopted policies that result in the country's resources being allocated inefficiently. Government failure, i.e where government intervention results in a net welfare loss might also be evident as part of poor governance.

7) Civil wars :

Civil wars, such as those that are occurring in Syria and the Democratic Republic of the Congo, disrupt growth and development. This is because they cause destruction of infrastructure, substantial loss of life which could reduce the size of the working population and reduce the country's productive capacity. They might cancel out any progress made in previous years.
All the above issues can deter both domestic investment and FDI and so limit the possibilities for growth and development.

8) Rapid population growth :
Population growth is particularly rapid in some of the poorest countries of the world such as Malawi and Mozambique. The population of Sub-Saharan Africa is projected to triple down from 1.2 billion to 4.2 billion during the 21st century.
In some countries where population growth is greater than the growth of GDP, GDP per capita will fall leading to lower living standards. It will lead to an increase in the dependency ratio which will limit the ability of households to save, worsening the problem of savings gap.
High population growth also puts a large strain on education, healthcare and infrastructure. This requires increased levels of government spending and can worsen the public finances.
It can also reduce the size of the labour force available to work as more parents stay at home to raise children.
Rapid population growth may lead to an increase in income inequality in the economy, if birth and death rates differ across socio-economic groups.
Lastly, population growth may also have environmental sequences including resource degradation, resource depletion, pollution and congestion.

Evaluation :

- More people are available to produce goods and services, so output may rise faster than population, therefore increasing per capita incomes.
- A larger working population leads to a downward pressure on wages and may attract FDI.
- Population growth creates a larger pool of potential innovators and therefore a larger stock of ideas and innovations that can be put into economic use. This can shift the LRAS rightward.
- Even if per capita incomes fall, development could occur in an economy. If there is more capital distribution of income in the economy.

9) Ageing population :
Most countries in Europe and Japan are facing an ageing population. An ageing population places a greater burden on the state because it may require greater public spending on state pensions, healthcare and social care. It leads to an increase in the dependency ratio.
This can lead to a greater tax burden on the workforce. With fewer workers, it will be hard to generate more output in the economy. This limits economic growth and makes development harder.

10) Poor infrastructure :

Infrastructure includes capital such as ports, transport networks, power, water supplies and telecommunication networks.
Poor infrastructure hampers growth because it causes higher costs and delays businesses, reduces mobility of labour and hits the ability of export businesses to get their products to international markets.
Poor infrastructure makes it difficult to attract both domestic and foreign investment and thus presents a significant obstacle to growth and development.

Evaluation :
On the other hand, a country rich in natural resources might benefit from FDI. TNCs might invest in the infrastructure of the country in order to facilitate its business. E.g new roads, thus benefiting the whole country. More than 2000 Chinese companies have invested in energy, mining, construction and manufacturing in Africa.

11) Geography :

Landlocked countries face higher transport costs when trading. This may act as a constraint on development because the country may have no direct access to markets abroad, especially if the road infrastructure is poor.
Furthermore, if a country is not geographically close to a large market then this might hinder progress because producers might not be able to sell products easily.
Two of such countries include Malawi in Africa and Kazakhstan in Asia. There are also other ways in which geography can hinder development. For example a dry climate that is unfavourable such as the long droughts in Sub-Saharan Africa each year.

Evaluation :
However, depending on the degree of development and other considerations, being landlocked may not pose economic disadvantages. Some historically landlocked countries are quite affluent, such as Switzerland.

12) Human capital inadequacies :

Countries with poor education standards and low school enrollment ratio will experience slower rate of economic growth because the productivity of the workforce will be low. It also discourages TNCs from investing in the country because of higher training costs.
Literacy in Mozambique is only 47 %.

Evaluation :
Rapid rates of economic growth in some countries will enable more resources to be devoted to health and education.

13) Terrorism :

Terrorism reduces FDI inflows in developing countries and can cause significant problems for countries that rely heavily on tourism as a strategy for growth and development. In Nigeria, it was estimated that terrorism caused FDI inflows to fall by $6.1 billion in 2010.

Evaluation :
However, individual terrorist incidents are likely to have a smaller impact than long-term terrorism problems.

STRATEGIES FOR GROWTH & DEVELOPMENT

A) Market-oriented strategies :

1) Trade liberalisation/Benefits of specialisation & trade :
   Trade between countries without trade restrictions or reductions of trade restrictions is known as trade liberalisation.

   It allows countries to specialise according to their comparative advantage→more efficient use of resources and greater trade→ allows economies to consume beyond their PPF

   Consumer benefit → lower price and more choice → consumer surplus increases

   Greater competition → Firms become efficient and reduce costs. Large scale production → economies of scale and lower LRAC→ global inflation rates fall

   Developing countries→greater access to markets in developed countries→ exports (X) ↑ → improved trade balance, GDP and employment increases. The earnings may be used for health, education, improved access to clean water → absolute poverty decreases

   Enables countries to become less dependent on foreign aid.

   Evaluation :

   1) Countries specialising on primary products will have worsening terms of trade which can increase the foreign currency gap.

   2) External cost and exhaustion of natural resources at a rapid rate

3) Specialisation on narrow range of goods → vulnerable to external shocks → decline in export earnings if global commodity price or demand falls

4) Workers in declining industries may face occupational immobility due to lack of skills → structural unemployment increases

5) Refer to unrealistic assumption of comparative advantage

2) Promotion of FDI (Check TNCs & FDI chapter)

3) Privatisation (Check supply side policy chapter)

4) Microfinance schemes :
Microfinance is a means of providing extremely poor individuals with small loans (micro-credit) who would otherwise not be able to take loans from the formal sector. Microfinance helps poor individuals to engage in productive activities, grow their tiny businesses and increase income. These schemes are often carried out by NGOs.
The main clients of microfinance are women, the self-employed, small farmers in rural areas, small shopkeepers etc.

Evaluation :

1) It is based on the idea that the poor can make themselves richer if they are provided with access to credit. In practice, wealth creation depends on the skills and knowledge of the individuals as well as institutions.

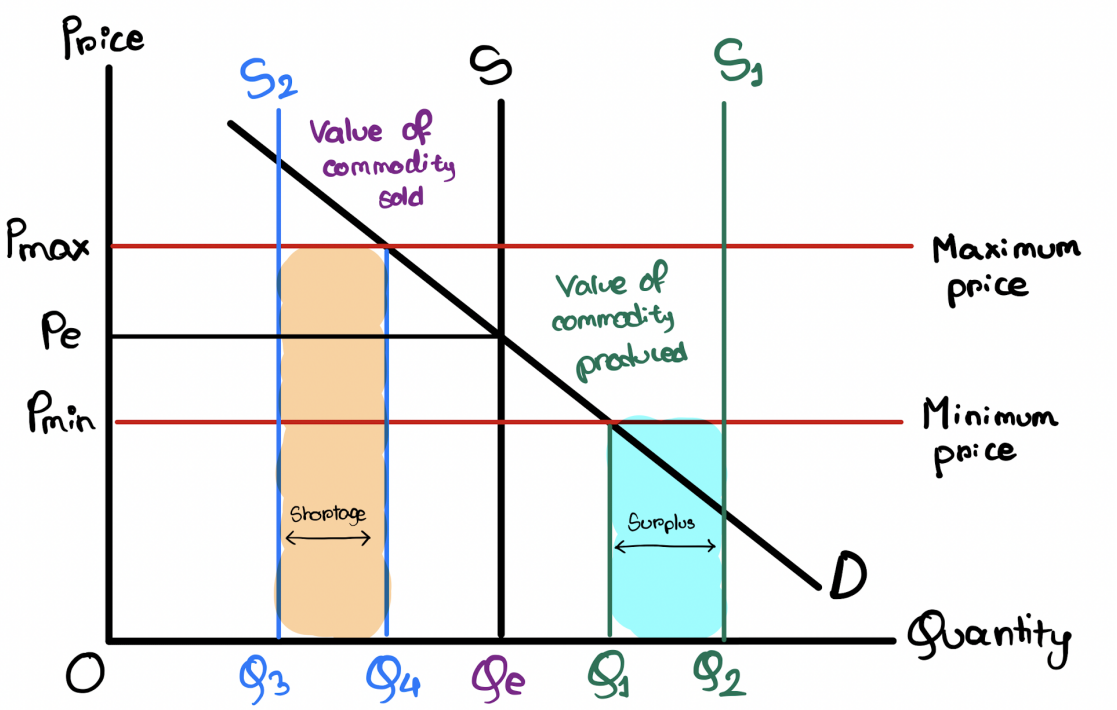
2) Debtors are charged very high interest rates. Many women have been forced to sell off essential items such as livestock and cooking pots to make their weekly payments.

3) There would be no benefit if loans are used for consumption purpose. Furthermore, the finance offered can be too low and so microfinance is not very successful at creating prosperous businesses in the long run.

B) Interventionist strategies/government-led strategies :

1) Development of human capital (check supply side policies)
2) Protectionism (check protectionism)
3) Infrastructure development (check constraint chapter & write with positive view)
4) Promoting joint ventures with TNCs (check unit 3)

5) Buffer stock schemes :
Buffer stock scheme seeks to stabilise the price of commodities by buying up surplus of the commodity when harvests are plentiful and releasing stocks onto the market when supplies are low.



If the price falls below the minimum price, for e.g. due to increased supply at times of better weather conditions then the government will purchase surplus stock from the market and store. I.e. Q_1-Q_2. This will reduce supply and prevent prices falling below P_{min}.
If the price increases above the maximum price due to lower supply at times of poor weather conditions then the government will release stocks onto the market from storage to meet the shortages. i.e. Q_3-Q_4

Evaluation :

- Setting up a buffer stock scheme requires a significant amount of finance by the government. There are large administrative, storage and transportation costs involved. This increases the opportunity cost for the government.

- Government may lack sufficient information in determining the maximum and minimum price, which can lead to huge expenditure and failure of the scheme. If the PES and PED for the commodity is elastic, then the surplus and shortages created will be larger.

C) Other strategies :

1) Aid :
   It refers to the voluntary transfer of resources from one country to another such as grants or loans given on concessionary terms.
   In 2020, the EU has provided £22.5 million in aid to Niger.

   Benefits :

a) If aid is used to help people access basic necessities such as food, shelter then it can reduce absolute poverty. This will help lower child and maternal mortality and thus increase HDI.

b) Provides funds for investment in infrastructure and technology → essential for industrialization → investment is an injection into the circular flow of income → multiplier effect on GDP → increase the mobility of labour allowing access to employment, education, healthcare.

c) Provides funds for investment in education which will increase the mean years of schooling → human capital and productivity increases in the long run → employment increases → standard of living increases → inequality and relative poverty falls in developing countries

d) Provides a financial inflow for low income countries → helps to fill up the savings gap → contributes to investment and economic growth according Harrod-Domar model

e) Aid can fill up the foreign exchange gap which may be used to import the necessary capital equipment → higher long run economic growth → employment and living standards increases

Evaluation :

1) Dependency culture → recipients of aid become dependent on aid and do not pursue appropriate macroeconomic policies to become independent leading to moral hazard. This has happened in Ethiopia.

2) Countries such as Liberia and Malawi have very low HDI ratings despite receiving large amounts of aid. This is because the funds may be diverted to government officials due to corruption and low levels of democracy.

3) Tied aid forces recipients of aid to buy goods and services from donor country firms which can lead to an inefficient allocation of resources.

4) Reinforces the dominance of donor countries over policy making and political issues of developing countries.

   Conclusion :
   A well directed and targeted aid can enhance a country's growth potential but there is a time lag.

2) Debt relief :
   Debt relief involves the cancellation, rescheduling or refinancing of a nation's external debt.
   Under the HIPC initiative, the World Bank and IMF provides debt relief packages to the poorest countries.

   a) Debt relief → fills up the foreign exchange gap → allows import of necessary capital equipment → higher GDP, employment, economic growth in the future → tax revenue increases, more funds for housing & healthcare
   b) It can break the cycles of debt where many debts are serviced or repaid simply through further borrowing.
   c) Countries could use the saved interest repayments to reduce absolute poverty.
   d) More resources for healthcare → life expectancy increases
   e) More resources for education → school enrollment ratio increases → literacy rates increases → higher productivity and increase in FDI flows
   f) Used the funds for investment in infrastructure → essential for industrialisation → investment is an injection into the circular flow of income → labour mobility increases allowing access to employment, education and healthcare

   Evaluation :
   1) In comparison with aid it can take a long time to qualify for debt relief programs

   2) Moral hazard → countries may not pursue sound macroeconomic policies if they expect future debts to be written off

   3) Corruption - Government might misplace financial benefits → money saved may not be spent to improve education and healthcare

   4) Many developing countries can not have the debts written off if their income per capita is too high to meet the IMF and World Bank criteria. Benefits of debt relief thus may not be realised by all countries.

3) Development of primary industries :
   Some developing countries have achieved growth and development on the basis of investing in the primary sector. For example : Chile has grown on the basis of its copper industry. This approach to economic development may be appropriate if :
   - The country has a comparative advantage and thus resources are allocated more efficiently
   - There is the potential for large growing demand for the primary product
   - The primary product attracts FDI which could promote growth and development

   Evaluation :
   Refer to the disadvantages of primary product dependency

   Conclusion :
   Successful economic development in commodity rich countries tends to result from the use of commodity revenue to diversify.

4) Industrialisation (the Lewis model) :
   The Lewis model of growth recommends development through industrialization. It is based on the view that development requires a move away from traditional agriculture to more productive manufacturing.

   This method of growth has been relevant to countries such as China, India & Bangladesh.

   This model describes the transfer of surplus labour from a low productivity agricultural sector to a high productivity industrial sector.
   If labour could migrate to urban areas and get employed in the secondary sector it would benefit the economy as each worker would produce more output.

   The marginal productivity of the agricultural workers would be close to zero because only surplus labours are transferred. This means the opportunity cost of transferring workers from the agricultural sector to the industrial sector would be close to zero.

   Evaluation :
- A large number of people may migrate from the rural area but may remain unemployed or underemployed. This could give rise to urban poverty, slums and a rise in crime rates in the cities. Thus inequality may rise.

- The theory also assumes that secondary sector production would be labour-intensive whereas it is often capital intensive suggesting that re-investment might be in capital equipment with the extra labour not needed.

5) Tourism :

Many developing countries are increasingly dependent on tourism from the developed world as demand for tourism is income elastic. In 2018, tourism contributed 67.1% of GDP for Seychelles.

1) Tourism is likely to attract FDI by TNCs on hotel chains and associated services → AD increases → economic growth increases through multiplier effect
2) The tourism is labour intensive → significant job creation → income and living standard increases → economic development increases
3) Expenditure by tourists on local goods and services is an invisible export and will improve the balance of payment current account. FDI associated with tourism will result in inflows on the capital and financial account. Both of these will help to fill up the foreign exchange gap.
4) Increased incomes, profits of firms and expenditure by tourists will mean more tax revenues for the government. This may be used to reduce fiscal deficit, improved public services and redistribute incomes
5) TNCs might invest in infrastructure such as roads, energy plants, hotels and associated services which will increase the LRAS

Evaluation :

1) Revenue from tourists may significantly fall during a recession since demand for tourism is income elastic.
2) There may be significant external costs such as increase in waste, pollution, destruction of ancient monuments and tourists might undermine local way of life and destroy cultural values.
3) Employment may only be seasonal and low paid as the jobs created are relatively low skilled. TNCs may also bring in their own managers.

Conclusion :

The economic impact of tourism depends on the size of tourism as a proportion of GDP. Impact of the current account depends also on the number of people travelling abroad from the domestic economy.

ROLE OF INTERNATIONAL INSTITUTIONS

Role of World Trade Organisation (WTO) :

- To encourage free trade :
  WTO aims to promote free trade by organising trade negotiations and encouraging countries to eliminate or reduce tariffs and other trade barriers among the member nations.

- To settle trade disputes :
  WTO also settles trade disputes. When a trade dispute arises between two countries, the WTO will organise meetings between the involved nations and act as a negotiator to reach a solution.

Role of World Bank :

- To promote long-term economic development & poverty reduction :
  The World Bank promotes long term economic development and poverty reductions by providing technical and financial support to help countries reform particular sectors or implement specific projects. For example - building schools and health centres, providing water and electricity etc.

Role of IMF :

- Surveillance :
  The IMF oversees the international monetary system and monitors the financial and economic policy of its members along with providing them with policy advice.

- Lending :
  To provide loans to countries that experience temporary current account deficits on their balance of payments.

- Stabilisation :
  To maintain exchange rate stability by ensuring international monetary cooperation between countries

Role of non-governmental organisations (NGOs) :
NGO is a non-profit organisation which works towards the betterment of the society.
Examples of NGOs include charities like Oxfam, Amnesty International which focuses on human rights issues and Greenpeace which focuses on ecological issues.
NGO activities include environmental, social and human rights work. They can work to promote social or political change on a broad scale or very locally.

INTERNATIONAL COMPETITIVENESS

International Competitiveness :
International competitiveness refers to the degree to which a country's products are attractive in terms of price and quality in the global marketplace.
Competitiveness can be measured in terms of price and non-price factors.

Measures of international competitiveness :

- Relative unit labour costs
- Relative productivity measures
- Relative export prices

Factors influencing international competitiveness :

A) Price Competitiveness :

1) Exchange Rate :
   A stronger exchange rate due to currency appreciation will increase the price of exports and reduce international competitiveness. In turn, it will improve the terms of trade.

2) Relative inflation :
   Increase in inflation rate, relative to other countries will make the countries products less price competitive.

3) Productivity :
   A rise in an economy's productivity relative to its main trading partners will increase the country's competitiveness. A highly trained and skilled workforce will be more productive and reduce unit labour costs.

4) Unit labour costs :
   Unit labour costs rise when wages increase faster than labour productivity. Countries such as China are highly competitive in manufacturing due to low labour unit costs.

5) Degree of regulation :
   Countries with only light touch regulation tend to be more competitive as regulation imposes costs on business and may discourage enterprise.

6) Non-wage costs :
   Non-wage costs such as health and safety regulations, anti-discrimination laws are much higher in developed countries and so it reduces their international competitiveness.

7) Quality of infrastructure :
   Poor infrastructure in roads, rail and air will increase the time it takes to transport goods, making it harder for firms to remain price competitive.

8) Non-price competitiveness :
   Non-price factors include quality, design and reliability. A higher reputation regarding quality can improve competitiveness and cause the demand for a country's product to be inelastic. Example - Japanese and German manufactured goods.

Evaluation :

- The exchange rate is particularly important for goods and services which compete on the basis of price and is likely to have a significant change in the volume of exports, if they have price elastic demand.

- TNCs might provide some infrastructure to the country in order to facilitate its business investment → may train local workers → productivity increases

- High inflation → exports decreases → demand for currencies fall → currency depreciation → may improve long term export competitiveness

Conclusion :
The competitiveness of a country's goods might not be the same as the competitiveness of its services. For example - USA competes on the basis of its service sector, compared to Vietnam who competes on the basis of its manufacturing sector.

Measures to increase international competitiveness :

1) Investment in all levels of education & training :
   Expenditure on provision and quality of education and training → human capital increases → labour productivity increases → cost per unit falls → international competitiveness increases

   Evaluation :
- Time lage
- Investment in education and infrastructure are the most important measures for long run productivity and attracts private sector investment and FDI.

2) Allowing currency depreciation :
   Reducing interest rates under monetary policy will lead to a depreciation of the currency. Lower exchange rate → relative export prices fall → price competitiveness increases

   Evaluation :
   The ability to manipulate exchange rates may be highly constrained as lower interest rates may lead to demand-pull inflation through a rise in consumption and investment. This can reduce export price competitiveness.

3) Incentives for investment :
   Subsidies or tax incentives may encourage firms to invest in innovation which would not otherwise be started due to the high risk and cost involved. This allows firms to gain technical economies of scale and dynamic efficiency.

   Evaluation :
   Incentives may be insufficient to encourage investment if business confidence is low and there is lack of long-term macroeconomic stability in the economy.

4) Investment in modern critical infrastructure :
   Developments to the infrastructure through improved transport links and communication will reduce costs → mobility of labour increases → efficiency increases → increased ability of export firms to get their products to international markets

   Evaluation :
   Considerable time lag → many years are spent on construction → opportunity cost

5) Increasing efficiency :
   Privatisation, deregulation and trade liberalisation will increase competition in the domestic markets making firms more efficient as barriers to entry to the market is low → cost per unit falls → market prices falls

   Evaluation :
   Some markets may be more efficient without competition such as natural monopoly as it allows greater economies of scale. Example - Railway

   Conclusion :
   Overall, any measures taken have to be considered in the context of a dynamic global economy where other countries are also trying to increase their competitiveness.

TRANSNATIONAL COMPANIES (TNCs)

TNC :
A company that has its facilities and other assets in at least one country other than its home country.

Advantages to a business of becoming a TNC/Reasons for FDI :

1) Access to more potential markets overseas which may have a rise in demand for the firms' products. Global presence strengthens brand recognition leading to increased sales and profits.
2) The home market of the TNC may be saturated or declining and so moving into other markets reduces reliance and spreads risks.
3) There is more scope for economies of scale. They can benefit from access to low cost locations, cheap raw materials and cheap labour as wages in developing countries tend to be low → costs decreases → profits increases
4) They might be attracted due to low levels of laws and regulations regarding environment, labour and safety.
5) Firms may operate transfer pricing to reduce tax liabilities. They may locate in low business tax countries and ensure their profits are registered there so that they can pay minimum tax.
   Ireland has one of the lowest tax rates in the EU at 12.5% and attracts many firms to Europe.
6) To gain a better understanding of markets, technology standards and policies in other countries.

Evaluation :

1) Potential diseconomies of scale → lack of control & communication issues

2) Unfamiliarity with overseas markets/economies - laws, customs, cultures, tastes etc. → which may mean products and services need to be adapted → may be risky

3) Possible legal restrictions on access; e.g - must engage in joint venture to operate

4) Little brand awareness; high setup costs; benefits are usually gained in the long run

Benefits of inward FDI for the recipient countries :

1) FDI will bring inflows on the financial account of the balance of payments. Any exports sold by the TNCs will lead to a long term improvement on the current account. Consequently there will be a rise in foreign currency earnings of the country. China had a trade surplus with the US of $421 billion in 2019.

2) TNCs will setup factories which will create jobs reducing unemployment and poverty. 33 % of the entire manufacturing workforce of China was employed as a direct or indirect result of FDI. Investment is an injection into the circular flow of income and will have a multiplier effect on GDP increasing economic growth.

3) The host country will benefit from transfer of technology, labour training and new management practices. This increase in the quality of both physical and human capital will help to increase productivity.

4) Governments will earn higher tax revenues from the TNCs. This can help to reduce the large fiscal deficits of developing nations and provide them with more funds to spend more on health, education and infrastructure.

5) Consumer choice increases as they will get a variety of goods and services at a lower price. This will raise living standards.

Evaluation :

1) Some local firms may face increased competition from the TNCs and be forced to shut down creating job losses. As a result the overall impact on job creation might be limited.

2) TNCs are likely to exploit workers in developing countries with cheap wages, longer working hours, poor working conditions and lower safety standards. They may also create environmental damage by increasing pollution in developing nations.

3) TNCs may engage in tax avoidance through transfer mispricing and pay minimal tax to the developing nations where they operate. This means that developing nations lose potential tax revenue which could have been spent on improving the living standards of the citizens.

4) Governments are at a risk of bribery and corruption. TNCs may exert political influence to gain contracts and control of resources or pass laws in their favour. e.g. on tax policies. This has been a major problem for many African and Asian countries.

Measures to control TNCs

FDI :
FDI is a direct investment in production made by a company in another country either in the form of establishing business operations or acquiring business assets in the other country.

FDI inflow = total direct investment into the country from all other countries

FDI outflow = total direct investment into other countries

Government measures to attract FDI into an economy :

1) Financial incentives; e.g. tax exemptions, lower tax rates, loan guarantees and lower interest rates

2) Investment in modern critical infrastructure

3) Removing excessive paperwork and administrative barriers

4) Invest in training programs so that foreign firms can fire a pool of skilled workers

5) Removing trade barriers to make it easier to import raw materials needed by TNCs

Evaluation :

1) Some measures may be implemented quickly. e.g. financial incentives but supply side measures such as improved infrastructure may be more effective in long term

2) Some measures such as tax exemptions can result into lower taxes and higher budget deficit increasing government debt

3) FDI to the economy may be low if rival economies are comparatively offering wider incentives and greater magnitude of benefits

4) Incentives may be insufficient to encourage FDI if businesses have low levels of confidence in the economy in terms of growth potential, macroeconomic and political stability.

Government measures to control TNC operations :

1) Tightening up rules (laws) on transfer pricing :
   Developing countries lose three times more to tax avoidance by TNCs than they receive in foreign aid each year. Governments must tighten up rules on transfer pricing to ensure that their tax administrations collect the right amount of tax. Furthermore legal actions should be taken against those who break the rules and to recover the unpaid taxes from them.

   Impact :
   TNCs will be forced to comply with these laws and it will lead to higher tax revenues for the government. This will lower the government's budget deficit and provide more funds for spending on education, healthcare and infrastructure. Compliance to these laws also reduces profits for TNC and so may encourage them to be more efficient to restore profits.

2) Stronger legislation and regulation of TNC activities :
   These can include imposition of strict employment laws, health and safety standards, minimum wages and price regulation.

   Impact :
   Such policies will restrict TNCs from worker and consumer exploitation in developing countries and improve living standards. It may help to alleviate poverty in the host country. This will enhance the TNCs reputation both within the country and in a global sense.

3) Governments may pass legislation to control mergers and takeovers to limit purchase of larger domestic businesses by foreign countries.

4) Provide incentives for domestic firms such as tax breaks, grants, to enable them to compete more efficiently with TNCs.

   Impact :
   Such policies will create a more competitive business environment.

Evaluation :

1) Some TNCs are very powerful and can lobby the government regarding policy making, bribe, corrupt tax officials and make financial contributions to political parties to influence them to take decisions in favour of the business.

2) Government may also be concerned about the threat of TNCs pulling out of the economy which can lead to further negative consequences such as reduction in economic growth, loss of jobs and competitiveness.

3) It can also be difficult to impose national laws and regulations on TNCs. Some TNCs may lack the willingness to comply and so a coordinated international effort may be needed at times.